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| In the Matter of | ) |
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| Access Charge Reform | ) CC Docket No. 96-262 |
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| Price Cap Performance Review for Local Exchange Carriers | ) CC Docket No. 94-1 |
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| Transport Rate Structure and Pricing | ) CC Docket No. 91-213 |
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| Usage of the Public Switched Network by Information Service and Internet Access Providers | ) CC Docket No. 96-263 |
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# REPLY COMMENTS OF THE AMERICAN ASSOCIATION OF RETIRED PERSONS, CONSUMER FEDERATION OF AMERICA, CONSUMERS UNION, AND THE TEXAS OFFICE OF PUBLIC UTILITY COUNSEL

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## TABLE OF CONTENTS

## EXECUTIVE SUMMARY

In this filing, the American Association of Retired Persons, the Consumer Federation of America, Consumers Union, and the Office of Public Utility Counsel (hereafter, Joint Commentors) reiterate our call for the Federal Communications Commission (hereafter, the Commission or FCC) to immediately lower the subscriber line charge and the access charges that long distance companies pay to local incumbents so that consumers can realize the benefits of the passage of the Telecommunications Act of 1996 (hereafter the Act) through lower telephone bills and greater competition in the local telephone market.

Throughout our comments in the proceedings ushered in by the passage of the Act, Joint Commentors have articulated an integrated set of pro-competitive public policy principles. We believe that these principles provide the foundation on which competition can flourish for the benefit of consumers of telecommunications services. We find it most gratifying that the vast majority of commentors in the access charge proceeding embrace these principles. Because real competition is in the public interest, it is not surprising that other public interest groups, numerous public advocates, and many public utility commissions support our views.

It is also not surprising that potential competitors -- new entrants -- support our views since only sound pro-competitive rules will give them a chance in the face of a one-hundred-year-old monopoly. It is surprising, however, to find that while the Baby Bells oppose our views in proceedings in this country, some support our views abroad. When these Baby Bells go abroad as potential competitors -- facing incumbent monopoly telephone companies in places like New Zealand, the United Kingdom and Europe -- they recognize the obstacles that incumbents place in the way of competition and the difficulties that competitors face in entering new market. As a result, the arguments they make overseas are almost identical to the arguments that have been made by consumer groups, consumer advocates, and some public utility commissions in the so-called trilogy of proceedings addressing the Telecommunications Act of 1996.

As a matter of general policy, we believe the record before the Commission supports the following principles and conclusions in the access charge proceeding. First, the Commission must actively prescribe access charge reform. Market forces are not strong enough to be relied upon to accomplish that goal. Second, the Commission must base access prices on efficient, forward-looking costs, as it has recognized in its interconnection order and as the Joint Board recommended in the universal service proceeding. Finally, the Commission must not engage in policies that insulate incumbent LECs from the competitive marketplace by making them whole for their past investments. These investments are inflated with excess profits, inefficiencies, and strategic investments.

With respect to specific mechanisms for achieving these goals, we believe the Commission has the clear authority and evidence to lower the SLC and mandate or oversee a complete pass-through of lower access charges in the form of lower basic long-distance rates. These steps alone would result in price reductions for consumers of approximately $5 billion per year. If the Commission will oversee the pass-through of access charges, despite its recent detariffing of the IXCs, then consumer groups would be able to determine that the pass-through has taken place. If not, then the Commission could eliminate the SLC. The elimination of the SLC would equal approximately the amount of the pass-through.

Once access charge reform is prescriptively set, the Commission can establish an alternative "market-based" track for access charge reform that might accomplish effective reform more quickly. But before instituting this approach, the Commission should require at least that the regulatory books of the LEC reflect a revaluation of assets and costs to TELRIC levels (accomplished by either reallocation of above-market assets to competitive categories or write-down of assets and that the LEC bear the burden of showing, subject to specific product and geographic criteria adopted by the Commission, that actual, effective competition exists for access in markets where pricing flexibility is sought.

Our final policy recommendation is that, as an incentive to ensure that the local monopoly is opened up, the Commission should not allow entry into in-region long distance until access charge reform is complete.

One of the central economic principles that has guided our comments in each of these proceedings is that the loop is a common cost of all services that use it. This view is shared by other public interest organizations and leads us to the conclusion that the SLC should be *reduced.*

Some of the Baby Bells overseas recognize that not only is efficient pricing necessary for the implementation of effective competition but that *timing* is the crucial element in the effective implementation of competition. These arguments explicitly recognize that the incumbent monopoly can use the collection of inefficient rents to hold off competition. Any policy that allows for such behavior ultimately hurts consumers and reduces the chances of effectively implementing the Telecommunications Act of 1996.

The Joint Commentors are particularly concerned about the Commission's suggestion that so-called "potential competition" could drive access charge prices down to efficient levels. We believe that potential competition imposes inadequate discipline on market behavior. Abroad, BellSouth New Zealand agrees with this observation . The Joint Commentors believe that only actual, effective competition will provide the public with the benefits of competition in the local telephone market. The inadequacy of the current state of competition to provide the market discipline the FCC wants and the Act demands has been noted by a number of commentors. Therefore, we urge the Commission not to dramatically reduce the extent of regulation, as suggested in its market-based approach.

The local exchange companies have complained long and bitterly that a forward-looking, engineering model approach to pricing access is unfair to them as incumbents.

These comments are in stark contrast with what some of these same companies say as potential entrants overseas. For example, BellSouth New Zealand argues that historical costs must be set aside and forward-looking, engineering costs be used to price interconnection, even if the technologies assumed are not actually in place. In spite of its pronouncements overseas, BellSouth appealed the use of forward-looking efficient costs in the Commission's Interconnection Order. This ironic contradiction underscores the fact that only when it is in their own interests do the Baby Bells recognize that the sound economic public policy is to prescriptively lower access charges to TELRIC.

US West International advocates a very rigorous form of incremental cost pricing for access. The company explicitly rejects the use of historical costs. It further argues that interconnection should be treated as an intermediate good, with no mark-up at all. We believe these arguments lend further support to our argument that the Commission should adopt, as fundamental, the principle that access charges (interconnection for the long-distance companies) be priced at forward-looking efficient prices.

Perhaps the ultimate irony in the Baby Bells' comments on efficient pricing in this proceeding is the thorough critique of the so-called "efficient component pricing rule" (ECPR) offered by both BellSouth and US West in overseas markets. Also known as the Baumol-Willig rule -- this approach to pricing has formed the cornerstone of the incumbent monopolist position in the U.S. Abroad, the Baby Bells argue that it has no relevance to real world situations.

All commentors but the domestic Baby Bells believe that this gap should not be filled by regulatory, make-whole policies. As the Baby Bells have argued overseas, the incumbent monopolist should not be reimbursed for excess profits and inefficient investment. Moreover, these Baby Bells state that the incumbent has a competitive advantage in a newly competitive marketplace and numerous, profitable revenue opportunities.

A full range of possibilities including basic service (e.g., second lines), vertical services, new telecommunications services (long distance) and new lines of business (video) has been identified as sources of new revenue to compensate incumbents for any reduction in access charges. Interestingly, in proceedings abroad, US West International makes the most fundamental observation about the availability of revenue opportunities. In addition, several commentors have remarked on the available opportunities in second lines. It is particularly interesting to note in this regard that the profitability of second lines stems from the existence of excess capacity. Others note that the extreme profitability of vertical service results from the availability of excessive functionalities. Finally, once the Baby Bells enter in-region long distance, they will be able quickly to gain market share and increase revenue. As noted in the Joint Commentors' initial filing, long distance is a very easy market for the ILECs to enter.

Given these immense revenue opportunities, to be pursued largely from an already installed base of assets, it is not surprising to find that when some of the Baby Bells go abroad as competitors, they are particularly hard on claims that incumbents must be protected from the impact of competition. Overseas, these Baby Bells insist that interconnection charges be set to compel greater efficiency, and they also recognize the immense advantages of incumbency.

BellSouth Europe argues that incumbents will easily be able to accommodate competition because inefficiencies will be weeded out, and inherited advantages will give the incumbents a head start in the new competitive environment. In fact, BellSouth abroad has identified precisely the list of factors cited in Joint Commenters' initial comments. In addition to the previously noted revenue opportunities/strategic investments, BellSouth overseas also comments on excess profits and inefficiencies, all of which should be disallowed. BellSouth New Zealand points out that the current excess profits of incumbents have not been earned, but are the result of the legacy of monopoly. DPSNY also points out that regulation has allowed profits to become excessive.

As noted in the initial comments of the Joint Commentors, it is unlikely that there are any stranded costs that would have to be recovered. However, even if such costs could be identified, a number of commentors noted that the ILECs have already been compensated or have been rewarded for the risks that they face.

In conclusion, the Joint Commentors believe that the Commission has the opportunity in this proceeding to bring immediate benefits to the small consumer. By taking the inefficiencies out of access charges, the Commission can lower the SLC and mandate the pass through of any reductions in access charges that the IXCs pay to the incumbent LECs without making the RBOCs whole. We believe that the RBOCs have been earning excess profits, have inefficiently built out their networks, have built-in advantages in a competitive marketplace, and will have tremendous new revenue opportunities under the Telecommunications Act of 1996.

Most importantly, some of the Baby Bells have recognized these arguments overseas. In attempting to get into the incumbent's market overseas, these Baby Bells have repeatedly argued that access and interconnection should be based on forward-looking, efficient costs. We believe that this argument is sound economically and would allow the Commission to give consumers immediate benefits in the form of lower prices and greater competition.

# I. INTRODUCTION

In this filing, the American Association of Retired Persons, the Consumer Federation of America, Consumers Union, and the Office of Public Utility Counsel (hereafter, Joint Commentors) reiterate our call for the Federal Communications Commission (hereafter, the Commission or FCC) to immediately lower the subscriber line charge and the access charges that long distance companies pay to local incumbents so that consumers can realize the benefits of the passage of the Telecommunications Act of 1996(hereafter the Act) through lower telephone bills and greater competition in the local telephone market.

## A. THE EVIDENTIARY RECORD

Throughout our comments in the proceedings ushered in by the passage of the Act, Joint Commentors have articulated an integrated set of pro-competitive public policy principles. We believe that these principles provide the foundation on which competition can flourish for the benefit of consumers of telecommunications services. We find it most gratifying that the vast majority of commentors in the access charge proceeding embrace these principles. Because real competition is in the public interest, it is not surprising that other public interest groups, numerous public advocates, and many public utility commissions support our views.

It is also not surprising that potential competitors -- new entrants -- support our views since only sound pro-competitive rules will give them a chance in the face of a one-hundred-year-old monopoly. It is surprising, however, that while some of the Baby Bells who oppose our views in proceedings in this country, support our views abroad. When these Baby Bells go abroad as potential competitors -- facing incumbent monopoly telephone companies in places like New Zealand, the United Kingdom and Europe -- they recognize the obstacles that incumbents place in the way of competition and the difficulties that competitors face in entering new market. As a result, the arguments they make overseas are almost identical to the arguments that have been made by consumer groups, consumer advocates, and some public utility commissions in the so-called trilogy of proceedings addressing the Act. When these Baby Bells are new entrants, they make a very good economic and public policy case for removing barriers to competition. Indeed, it may well be that because of their success in impeding competition at home, they are particularly astute at pointing out the barriers to competition abroad.

If the Commission's goal is to create the competitive industry intended by the 1996 Act, it must take the advice of those whose true interests lie in creating competition -- consumers, competitors and public interest organizations. In these reply comments, we review the various ways in which these groups have explained the key elements of a pro-competitive access charge policy. This review clearly indicates that there is only one way to implement effective competition in the local telephone market: by prescriptively lowering the access charges, including the subscriber line charge (SLC). We rely on basically four sets of comments in building our reply:

1. The comments of the Baby Bells abroad
2. The comments of regulatory bodies
3. The comments of consumer groups
4. Empirical studies entered into the record

These four sets of comments provide the basis for prescriptively reducing access charges to efficient levels, action which will allow consumers to realize immediate benefits from the Telecommunications Act of 1996.

## B. PUBLIC POLICY RECOMMENDATIONS

As a matter of general policy, we believe the record before the Commission supports the following principles and conclusions in the access charge proceeding.

- oThe Commission must actively prescribe access charge reform. Market forces are not strong enough to be relied upon to accomplish that goal.

- oThe Commission must base access prices on efficient, forward-looking costs, as it has recognized in its interconnection order and as the Joint Board recommended in the universal service proceeding.

- oThe Commission must not engage in policies that insulate incumbent LECs from the competitive marketplace by making them whole for their past investments. These investments are inflated with excess profits, inefficiencies, and strategic investments.

With respect to specific mechanisms for achieving these goals, the Commission has the clear authority and evidence to take the following steps.

1. The Commission should lower the total of federal per minute charges by approximately 50 percent, reflecting the elimination of excess profits, the incorporation of a higher productivity factor, recognition of new revenue opportunities, and reallocation of risk under the price cap form of regulation.

2. The Commission should ensure the pass-through of at least half of these reductions by a reduction in the subscriber line charge.

3. The Commission should also order that the other half of these reductions (to the CCL and the TIC) be passed through directly to consumers in the form of lower basic long distance rates.

These three steps alone would result in price reductions for consumers of approximately $5 billion per year. If the Commission will oversee the pass-through of access charges, despite its recent detariffing of the IXCs, then consumer groups would be able to determine that the pass-through has taken place. If not, then the Commission could eliminate the SLC. The elimination of the SLC would equal approximately the amount of the pass-through.

4. Finally, the Commission should institute a proceeding that formally shifts the basis of all interstate costs to TELRIC. This will result in additional reductions of costs recovered in the interstate jurisdiction by several billion dollars.

With respect to the timing of these steps, we recommend the following.

1. The Commission should begin the process of lowering rates *immediately*.

2. The Commission should establish a fairly short transition period (perhaps three years) to accomplish the entire task of access charge reform.

The above prescriptive approach assures that access charge reform will be achieved in a reasonable time frame. Once access charge reform is prescriptively set, the Commission can establish an alternative "market-based" track for access charge reform that might accomplish effective reform more quickly. But before instituting this approach, the Commission should require at least two showings by LECs seeking market-based pricing of access.

1. The regulatory books of the LEC must reflect a revaluation of assets and costs to TELRIC levels, accomplished by either reallocation of above-market assets to competitive categories or write-down of assets.

2. The LEC must bear the burden of showing, subject to specific product and geographic criteria adopted by the Commission, that actual, effective competition exists for access in markets where pricing flexibility is sought.

Our final policy recommendation is that, as an incentive to ensure that the local monopoly is opened up, the Commission should not allow entry into in-region long distance until access charge reform is complete. In other words, until competition is viable in the access market -- either through the RBOCs' compliance with the pricing of unbundled network elements at forward-looking efficient prices or through the pricing of access by the incumbent price-cap LECs at forward-looking efficient prices -- the RBOCs should not be allowed into the in-region long distance market. These requirements would level the playing field and allow for the development of true and effective competition that will ultimately benefit consumers in the form of lower prices.

## II. THE SUBSCRIBER LINE CHARGE

One of the central economic principles that has guided our comments in each of these proceedings is that the loop is a common cost of all services that use it. This view is shared by other public interest organizations in their initial comments.

> On the contrary, the loop (and other "fixed" costs associated therewith) consists of facilities necessary for the creation of communication paths between two or more users. Consequently, the loop benefits not only the subscriber to that loop, but all those who use that loop to complete a connection to that subscriber (hence the name "common line"). Therefore, it is reasonable to expect that rates for all services that utilize the loop should recover a portion of its costs. (DPSNY, p. 5).

> The CCLC payment by the IXC is a payment to support a portion of the costs of the network facilities used. Those interexchange services share, use, benefit from, and depend upon the shared portions of that network (State Advocates, p. 13).

Given that economic efficiency demands dramatic reductions in loop costs and recovery of those costs from long distance companies, the Joint Commentors concluded that the subscriber line charge should be *reduced*, not increased, as the Commission suggested. A number of public interest groups took a similar position in their initial comments:

> Proposals to increase, directly or indirectly, the subscriber line charge ("SLC") and other end user charges should be rejected (DPSNY, p. 4).
>
> Any rate structure modifications should not directly or indirectly result in a new flat-rate charge to end users. Rather, we recommend that the "bulk billing" or "capacity charge" options discussed in para 61 be adopted (Florida PSC, p. 2).
>
> The Commission may agree that CCL costs recovered on a per minute of use basis is inefficient. However, we do not agree with any options that would effectively impose additional flat monthly charges directly on the end-user, even for second residential lines. . .
>
> This Commission also opposed increasing or eliminating the cap on SLCs, and is concerned with the difficulties of having different charges assigned to primary and second lines (South Dakota Public Service Commission, pp. 2-3).
>
> The PUCO opposes any increase to the SLC for all residential and nonresidential access lines. The PUCO maintains that the net effect of this proposal would simply result in a shift in cost recovery from interexchange carriers to end users. As an alternative to placing the entire responsibility on end-user customers for the cost recovery of the local loop, assigned to the federal jurisdiction, the PUCO maintains that IXCS should also be responsible to recover some of the costs of the local loop (Public Utility Commission of Ohio, p. 1).
>
> The SLC, which is presently capped at actual or $3.50 per month for residential and single-line business and $6.00 for multi-line business, should be eliminated (Oregon Public Utility Commission, p. 5).
>
> The Alabama PSC opposes any plan that would increase or eliminate the cap on the SLC. We maintain the same opposition to the imposition and increases in SLC as we have expressed in prior proceedings. We continue to oppose the recovery of common line costs assigned to the interstate jurisdiction through the imposition of flat rate charges to captive subscribers who may or may not use interstate services. (Alabama Public Service Commission, p. 6).
>
> The Texas PUC opposes a plan that would increase or eliminate the cap on the SLC, consistent with our many past objections to the imposition and increases in this charge since its inception. We continue to oppose the recovery of common line costs assigned to the interstate jurisdiction through the imposition of flat rate charges to captive subscribers who may or may not use interstate services (Texas Public Utility Commission, p. 6).

> To the extent that residential consumers remain captive customers, allowing LECs to impose an increased share of costs upon residential end-users preserves monopoly profits. Thus, the SLC should stay as is (or be reduced, as the Federal-State Joint Board has recommended) (Ohio Consumers' Counsel, p. 9).

Thus, strong support exists for our call to reduce the SLC. The alternative, an *increase* in the SLC, would simply allocate a larger share of common interstate costs to the captive end user. Such a policy would have the effect of raising prices for consumers -- an unacceptable result that is the exact opposite of the intent of the Act.

## III. THE CHOICE BETWEEN MARKET-BASED AND PRESCRIPTIVE REFORM

One of the central issues in the Access Charge Notice is whether or not to rely on the introduction of competition to achieve the necessary reforms in the pricing of access. The Joint Commentors argued in their initial comments that competition is not sufficiently developed to accomplish the Commission's goal. Furthermore, we fear that giving the incumbents increased pricing flexibility before market forces are adequately developed will frustrate the eventual development of competition in the local telephone industry. We find strong support for this view in the comments of others. Most striking is that some of the strongest arguments come from some of the Baby Bells themselves in proceedings abroad.

### A. INCUMBENTS HAVE AN INTEREST IN AND THE ABILITY TO SLOW THE ONSET OF COMPETITION

It is clear that incumbents have an incentive to stymie competition. BellSouth New Zealand offers the following observation on the incentives and powers of incumbents to slow down competition.

> The timing of, terms and conditions for, and pricing of, interconnection determine which firms capture the available rents. Hence, the dominant incumbent, if it fails

> to accept the benefits which flow from a competitive market, can and will rationally use interconnection negotiations to delay and restrict the benefits of competition. This enables it to perpetuate the rents which it obtains as a successor to a monopoly franchise at the expense of competition and innovation.
>
> A dominant incumbent can limit both the scale and scope of its competitors, raising their costs and restricting their product offerings. In addition, it can divert or delay competition and innovation to protect its current revenues and give itself time to prepare and introduce similar products or service by exercising control over standards for connect and over local numbers. (BellSouth New Zealand, <u>Submission: Regulation of Access to Vertically-Integrated Natural Monopolies</u>, A Discussion Paper, 29 September 1995, p. 2; hereafter, Bell South New Zealand).
>
> It has very powerful incentives to include monopoly rents in the price of complementary network services in order to perpetuate and increase its monopoly profits. It similarly has very powerful incentives to reduce the ability of its competitors to claim market share (BellSouth New Zealand. p. 10).

Obviously, the comments submitted by BellSouth overseas in formal proceedings seeking to introduce competition into a monopolistic market structure contradict their claims made in this and other proceedings before the Commission. In fact, the Baby Bells overseas recognize that not only is efficient pricing necessary for the implementation of effective competition but that *timing* is the crucial element in the effective implementation of competition. These arguments explicitly recognize that the incumbent monopoly can use the collection of inefficient rents to hold off competition. Any policy that allows for such behavior ultimately hurts consumers and reduces the chances of effectively implementing the Act.

## B. POTENTIAL COMPETITION IS INADEQUATE TO DISCIPLINE MARKET BEHAVIOR

The Joint Commentors are particularly concerned about the Commission's suggestion that so-called "potential competition" could drive access charge prices down to efficient levels. We believe that potential competition imposes inadequate discipline on market behavior. BellSouth New Zealand agrees with this observation.

> What is needed to ensure the efficient combination of competition and innovation is entry. The *mere threat* of entry will *not* provide the mechanism of dynamic competition, which requires that firms continually compete via innovation and interact with each other in the marketplace. This is a process of seeking out innovations, and developing and introducing new services to achieve competitive advantage...
>
> This calls for multilateral competition between a number of innovative and technologically alert firms. Competition between multiple sources of innovation provides the necessary variety of innovation from inside and outside the industry; the volume of resources to invest in new services; and the 'high powered' incentives to compete by innovation (BellSouth New Zealand, p. 22, emphasis added).

In essence, the Joint Commentors believe that only actual, effective competition will provide the public with the benefits of competition in the local telephone market. "Potential competition," or in BellSouth New Zealand's words -- "the mere threat" of competition -- does not provide the necessary incentives to bring about competition in the access market.

## C. CURRENTLY, MARKET FORCES ARE TOO WEAK TO BE RELIED UPON TO PRODUCE THE NECESSARY REFORMS

Having rejected the idea that potential competition will lead to efficient pricing of access, we focus on the current state of competition. We conclude that competition is not sufficient at present to do the job. Therefore, we urge the Commission not to dramatically reduce the extent of regulation, as suggested in its market-based approach.

Interestingly, BellSouth New Zealand complained that light-handed regulation is insufficient to compel efficient interconnection.

> Whilst the policy of light-handed regulation has eliminated statutory barriers to entry and allows market forces to operate in the supply of composite goods and services to end users, the requirement in the telecommunications industry for interconnection enables the dominant incumbent to delay entry and restrict the ambit and extent of competition through lengthy negotiations, higher transaction costs and the lack of an outcome in the market for complementary network services (BellSouth New Zealand, p. 13).

The inadequacy of the current state of competition to provide the market discipline the FCC wants and the Act demands has been noted by a number of commentors. For example, the Florida Public Service Commission offers the following observation.

> While our preference is to rely on market based approaches wherever possible, we do not believe that this approach can effectively lower access charges, at least for the present time. The one area where a market based approach might be effective in the near term is with transport; however, the presence of competitive alternatives for transport is thought to vary widely by locale. For the other access charge elements, competitive alternatives will likely emerge slowly, if at all, particularly in the case of terminating access. Florida, PSC, p. 7).

We agree with BellSouth New Zealand and the Florida Public Service Commission that regulators must take a firm approach in lowering access charges. Currently, effective, actual competition does not exist. Instead, at the request of the local incumbents' trade association (and others), the Commission's Local Competition Order has been stayed pending resolution of an appeal. <u>Iowa Utilities Bd. v. FCC</u>, Case No. 96-3321 (consolidated). In addition, GTE has appealed arbitrated agreements in the states that have recognized forward-looking efficient pricing of interconnection. Not only have these actions cut off even the hope of competition in the access market through the use of forwarding-looking, efficiently-priced unbundled network elements, but they are exactly the types of tactics that BellSouth New Zealand argues incumbents will use to delay competitive entry.

## IV. EFFICIENT PRICING

A second major area of comment deals with the principles on which efficient prices should be set. We advocate setting prices at the level of efficient forward-looking costs.

### A. FORWARD-LOOKING, EFFICIENT COSTS MUST BE THE BASIS FOR PRICING OF INTERCONNECTION AND ACCESS

The local exchange companies have complained long and bitterly that a forward-looking, engineering model approach to pricing access is unfair to them as incumbents. Bell South stated in its initial comments that " . . . a prescribed reinitialization of LEC access rates to TSLRIC or TELRIC derived levels would be wholly inappropriate." And, they conclude that "there are fundamental problems with using TSLRIC or TELRIC as the measure of LEC 'costs'." Initial Comments of BellSouth, In the Matter of Access Charge Reform, Price Cap Review for Local Exchange Carriers, Transport Rate Structure and Pricing, and Usage of the Public Switched Network by Information Service and Internet Access Providers, Federal Communications Commission, Docket Nos. 96-262, 94-1, 91-213, 96-263, January 29, 1997. These assertions are in stark contrast with what BellSouth has said as a potential entrant overseas. BellSouth New Zealand argued that historical costs must be set aside and forward-looking, engineering costs be used to price interconnection, even if the technologies assumed are not actually in place.

> . . .Telecomm [the incumbent LEC in New Zealand] has an incentive to report Long Run Average Incremental Cost (LRAIC) based on historical costs, the appropriate way to measure costs is forward-looking and Telecomm's reported LRAIC will therefore perpetuate a cost structure that reflects any past inefficient

> investment decisions that it made. For this reason, engineering process models should be used to project future costs of access using the available technology most likely to be used - whether or not that is the current technology used by Telecom (BellSouth New Zealand, p. 75).

BellSouth New Zealand offers a range of prices which can be considered "subsidy free." The lower boundary is the long-run incremental cost, while the upper end is the forward-looking, efficient stand-alone cost.

> A minimal restriction on a dominant incumbent is that interconnection charges fall between average incremental cost and average stand-alone cost.
>
> Care needs to be taken in computing stand-alone costs. It is necessary to ask what the costs are of providing access on stand-alone basis given by best practice (i.e., the most advanced state of knowledge of, and expertise used by, any network operator). This requires the separation out only of those expenditures necessary to provide interconnection services. In addition, it is necessary to require that the dominant incumbent use in its computation, regardless of the actual technology use in its network, "best practice" technology. Otherwise, it will inflate the costs of interconnection. (BellSouth New Zealand, p. 70).

In spite of its pronouncements overseas, BellSouth appealed the use of forward-looking efficient costs in the Commission's Local Competition Order. Iowa Utilities Bd. v. FCC, Case No. 96-3321 (consolidated). This ironic contradiction underscores the fact that only when it is in their own interests does BellSouth recognize that the sound economic public policy is to prescriptively lower access charges to TELRIC.

This policy regarding access charges is well known in this country, as noted by The Group of State Consumer Advocates.

> The incremental cost is just one of the economic costs. It is the one that sets the lower boundary of where reasonable prices should fall. The other economic cost is the stand-alone cost which sets the upper boundary of where reasonable prices should fall. (Comments of The Group of State Consumer Advocates, p. 11, hereafter, State Advocates).

For these reasons, we believe the Commission should adopt, as fundamental, the principle that access charges be priced at forward-looking efficient prices.

B. ELIMINATION OF MARK-UPS

The fact that there is a range of "subsidy-free prices" points directly to another important element in the debate over efficient pricing -- mark-up policy. Joint Commentors embraced TELRIC pricing, which accepts the notion of the allocation of common costs to all services sold. The identification of fairly small, common costs has been roundly criticized by the LECs. They insist that mark-ups be large. Abroad, they take the opposite position.

BellSouth Europe proposes that mark-ups be linked to the level of costs observed in competitive industries. This would certainly force the incumbents, whose common costs are much higher, to either not recover those costs or get them from other services.

> Since the incumbent carrier has ample latitude to rationalize its costs in the short-term, proportionate recovery of joint and common costs should be limited by global "best practice" benchmarks for such costs established by incumbents in other fully competitive markets (BellSouth Europe, Comments of BellSouth Europe to the European Green Paper on the Liberalisation of Telecommunications Infrastructure and Cable Television Networks, March 15, 1995, p. 13, hereafter, BellSouth Europe).
>
> Interconnection charges should largely reflect long-run incremental costs (LRIC)caused by the interconnection. (BellSouth Europe, p. 13).

In fact, BellSouth Europe goes on to suggest that interconnection charges actually handicap incumbents to level the playing field for new entrants, like itself in Europe.

> Interconnection charges should be sufficiently reduced to factor-out the incumbents structural market advantages and superior access advantages (if any). (BellSouth Europe, p. 13).

US West International advocates a very rigorous form of incremental cost pricing for access. The company explicitly rejects the use of historical costs. It further argues that interconnection should be treated as an intermediate good, with no mark-up at all.

> The purpose of LRIC is to ensure that interconnected operators fully re-imburse each other for the costs incurred - but only the costs incurred - in their interconnection. Arbitrarily increasing these sums by some mark-up, to bridge the gap between LRIC and accounting measures of total cost of yesterday's network in today's prices, rather defeats the object of using LRIC in the first place.
>
> The provision of call completion, as part of the public policy of "any-to-any" calling, is more properly seen as a cost which should be recovered, rather than as a source of revenue. Operators should make their "mark-up" on their retail services which, given our narrow definition of interconnection, will form the overwhelming bulk of their income. This distinction between interconnection and retail sales is critical.
>
> Telephone operators do not set-up in service to charge each other for interconnection; their aim is to retail service to customers. It is these retail customers who should pay for the "overhead" costs of operating the company; billing systems, corporate advertising, board salaries, and so forth. If the company is a successful competitor, it will make profits in the market; if not, not. It is the job of each company to cover its own overheads and- if it can - make a profit. It is not the job of other operators to ensure that one particular company's overheads are met through passing on interconnection mark-ups to their customers...
>
> US WEST therefore believes that correctly calculated LRIC, which includes an appropriate rate of return for capital employed, is the correct basis of interconnection tariffs and no further mark-up should be added. (US West International, A Framework for Effective Competition: A Response to OFTEL's Consultative Document for US West International, February 6, 1996, p. 14, hereafter, US West International).
>
> The tariff for interconnection between originating and terminating network operators should be calculated through a "bottom up" approach which identified the cost drivers and their long run incremental cost (LRIC), including the appropriate contribution to the cost of capital. There should be no arbitrary mark-up to this LRIC, as any attempt to add common or overhead costs will distort the market, serve as a barrier to effective competition and operate against the public good of "any to any" calling. (US West International, p. 2).

This extensive statement by US West International clearly lays out the economic and public policy argument that we ask the Commission to accept in this proceeding and that the Commission has already accepted in the Local Competition proceeding: sound economic and public policy dictates that access charges be set at forward-looking efficient prices in order to bring about effective competition in local telephony.

## C. CRITIQUE OF THE OPPORTUNITY COST RULE.

Perhaps the ultimate irony in these Baby Bells' comments on efficient pricing is the thorough critique of the so-called "efficient component pricing rule" (ECPR) offered by both BellSouth and US West in overseas markets. Also known as the Baumol-Willig rule -- this approach to pricing has formed the cornerstone of the incumbent monopolist position in the U.S. Abroad, these Baby Bells argue that it has no relevance to real world situations. More importantly, given the current structure of telecommunications markets, the make-whole approach explicit in ECPR -- combined with pricing flexibility demanded by Baby Bells under ECPR in the U.S. -- would be disastrous for consumers and competition. BellSouth New Zealand offers the following critique:

> The Baumol-Willig rule maximizes social welfare only in a static world and then only if a stringent set of assumptions are valid. These assumptions are:
>
> > the dominant incumbent prices a complementary service based on a marginal cost pricing rule
> >
> > the dominant incumbent's and the new entrant's or rival producer's respective components are perfect substitutes . . .
> >
> > the production technology of component services experiences constant returns to scale
> >
> > An entrant incurs no fixed costs (no entry barriers)

The new entrant or rival producer has no market power

The dominant incumbent's marginal costs (or average incremental cost) of production of components can be accurately observed. (BellSouth New Zealand, p. 17).

As a result, BellSouth New Zealand states that the Baumol-Willig rule:

Fails to promote or achieve overall (allocative, productive and dynamic) efficiency even in the "simplest, static and no-uncertainty" context...

Acts to perpetuate high prices, limit entry, restrict, prevent and even eliminate competition and retard innovation. (BellSouth New Zealand, p. 69).

The inclusion of monopoly rents in the interconnection charges, as the Baumol-Willig rule proposes, creates significant adverse economic inefficiencies (BellSouth New Zealand, p. 72).

US West International offers the following observations.

The ECPR depends on a number of assumptions about the market-place which, in the case of telecommunications, are clearly not valid:

perfectly substitutable, homogeneous products;

competition only through price;

a single technology used by all service providers;

efficient costs operations by the incumbent;

incumbent prices equal to social marginal costs, based on the best available technology.

If these assumptions were to hold, then there would be no basis for competitive entry since society's resources would be already used to maximum efficiency, and social welfare could not be improved by competition.

We agree with the criticisms of ECPR made by OFTEL. It is effectively a tool to protect incumbent monopolists (US West International, p. 29).

Thus, since none of the assumptions upon which the Baumol-Willig Rule is based exists in the current telecommunications industry in the U.S., the arguments made against efficient pricing by the Baby Bells should not apply in this proceeding. Instead, efficient prices should be adopted by the Commission based on the TELRIC methodology it outlined in the Local Competition Order.

## V. UNDERSTANDING THE GAP BETWEEN EFFICIENT COSTS AND THE EMBEDDED COST CLAIMS OF THE INCUMBENTS

The ultimate issue raised by the Commission in the Access Charge Notice is what to do with the gap between efficient, forward-looking costs and the embedded costs claimed by the incumbent LECs. All commentors but the domestic Baby Bells believe that this gap should not be filled by regulatory, make-whole policies. In contrast, the Baby Bells overseas are extremely critical of the efforts of incumbents to use interconnection tariffs to protect their revenue streams which consist of embedded excess profits and inefficiencies.

The New York State Department of Public Service has done a yeoman's job in its initial comments of outlining the many factors that should be included in the analysis of how much to reduce access costs. All told, the DPSNY identifies over half a dozen factors that will allow access to be reduced by over 50% without increasing any other rates or charges.

> There are other factors that may justify interstate access charge reductions. These include, for example, the possibilities that current price caps should be adjusted downward to reflect lower capital costs; that higher productivity factors are appropriate; and that equal access network reconfiguration costs, now fully amortized, should be removed from rates...

> Beyond these, other factors will likely cause the per minute price of interstate access to fall further in the future. The current growth of interstate access minutes of use should cause per minute prices to decline, because the incremental cost of access is well below the average price of access. New York PSC, p. 2.
>
> The above interstate carrier access reductions do not reflect 1) an appropriate adjustment in the starting point rates for carrier access (to eliminate the extraordinary increase in interstate earnings levels allowed by the past regulatory approach), 2) the transfer of risk of recovery of uneconomic costs in embedded plant (a risk that is fully borne by entities operating in a fully competitive environment), and 3) the potential gains available to LECs via their entry into markets that they formerly precluded entry from....
>
> In addition to the above competitive environment changes, two additional factors will allow access charges to be lowered even further. First, corporate consolidations, as exemplified by PacTel/SWB and Bell Atlantic/NYNEX, would facilitate the achievement of cost savings beyond the productivity savings currently anticipated...
>
> Second, the resale of incumbent telephone company services now being implemented (and facilitated by significant wholesale discounts) will result in substantial operating cost reductions. (New York PSC, Attachment 1, pp. 6-7.)

These factors reflect the fact that access charges can be lowered prescriptively without raising rates or charges in other areas. We believe the Commission can adopt sound economic policy in this proceeding without indemnifying the Baby Bells for the gap between embedded and forward-looking efficient costs. As some of the Baby Bells have argued overseas, the incumbent monopolist should not be reimbursed for excess profits and inefficient investment. Moreover, the incumbent has a competitive advantage in a newly competitive marketplace and numerous, profitable revenue opportunities.

## A. REVENUE OPPORTUNITIES

One area that has received considerable attention in the comments is the availability of many sources of new revenue to compensate incumbents for any reduction in access charges. A full range of possibilities including basic service (e.g., second lines), vertical services, new telecommunications services (long distance) and new lines of business (video) has been identified.

Interestingly, US West International makes the most fundamental observation about the availability of revenue opportunities.

> US WEST has previously argued against the concept of an "access line deficit." To reiterate our position, we do not believe that any sensible separation can be made between the provision of exchange lines and call used. It is rather like Sainsbury's arguing that they make a terrible loss on the provision of supermarkets, while ignoring the profit they make from selling their goods. The "access line deficit" is an accounting deficit, not a cash deficit. US West International, p. 12.

The DPSNY identified several of the new revenue opportunities.

> Additionally, BOCs entering the interLATA interexchange business (and potentially other new businesses, such as video) may be able to utilize existing network and operational resources, including common overheads, in those endeavors. To the extent this is true, the associated costs should be transferred from existing services, including interstate access, to the new interLATA operations. Further, the interstate portion of cost savings resulting from industry structure changes, such as the Bell Atlantic/NYNEX and PacTel/SWBell mergers, could be identified and removed from interstate access prices. (New York PSC, pp.5-6).

In addition, several commentors have remarked on the available opportunities in second lines.

> Interstate carrier access charge reductions need not result in SLC increases for multi-line business customers and for residential customers subscribing to additional lines. On the contrary, as explained in Attachment 1, we believe that carrier access charge reductions of 50% or more over the next few years should be obtainable without SLC increases. Moreover, recent statements asserting that additional lines are highly profitable for the LECs* suggest there is no need to increase the prices (SLC) of these lines in particular.
>
> */ See e.g. comments of Raymond Smith, Chief Executive of Bell Atlantic: "Sales of secondary lines at Bell Atlantic increased more than 50 percent, fueled by surging demand for Internet and telecommuting applications... The revenue generated substantial profit because we were able to provision new lines and services from idle capacity in an existing plant." Industry: Internet No Burden on Phone System, Reuters, January 23, 1997. (New York PSC, pp. 5-6).